

FEDERAL POLICY RESPONSES TO THE PREDICAMENT OF MUNICIPAL FINANCE

INTRODUCTION

Jefferson County's debt crisis provides policymakers the opportunity to reconsider the role of the federal government in the regulation of municipal finance markets, and whether changes in federal regulation alone are enough to prevent municipalities from running into the same problems that Jefferson County encountered. That analysis must begin with an examination of the causes of the crisis. The external causes of Jefferson County's financial implosion have received considerable attention and are well understood: credit rating agencies downgraded the bond insurers that had guaranteed the county's variable-rate bonds, which accelerated the county's debt, coupled with the county's hedging strategy that turned out to be a losing bet on interest rate spreads. Although it is tempting to blame the county's parlous fiscal condition entirely on these external factors, blaming the municipal finance markets alone would be a mistake. Regulatory reform that focuses only on these external factors runs the risk of missing the political fragmentation and weak governance inside the county that set the stage for the county's fiscal collapse.¹ Improving the regulation of the municipal bond market is a task that is as important as it is timely, but until local governance is made effective and accountable to taxpayers and ratepayers, regulatory improvement is, at best, only a partial solution.

Jefferson County's descent into financial calamity begins with a grimy problem: raw sewage. After the county put off sewer system upkeep for decades, heavy rains overwhelmed the county's dilapidated sewer lines and sewage overflowed into the Cahaba and Warrior river

¹Robert J. Landry & Cynthia McCarty, *Causal Factors Leading to Municipal Bankruptcies: A Comparative Case Study*, 28 MUNICIPAL FINANCE JOURNAL 19, 30 (2007) (noting common systemic problems that have contributed to two different municipal bankruptcies).

basins. As a result of the county's deferral of sewer maintenance and its failure to build adequate treatment facilities, the county was sued under the Clean Water Act. The county settled the suit by entering into a consent decree that required the county to rehabilitate the sewer system deficiencies in an impractically short period of time. The consent decree required the county to remedy decades' worth of neglect within twelve years and to assume responsibility for maintaining additional sewer lines that had formerly been administered by cities within the county.²

To pay for the improvements mandated by the consent decree, Jefferson County turned to the municipal finance market. Although local governments frequently tap the municipal finance market to raise funds to pay for long-term projects, conflicts of interest and complexity in the municipal finance market can sometimes trap the unwary, particularly when local officials lack the expertise to independently assess the terms of the financing structures proffered by sophisticated underwriters. But Jefferson County's flawed form of county governance magnified these risks inherent in the municipal finance market. The county's fragmented political leadership and feckless governance structure laid the foundation for risky borrowing and stymied fiscal responsibility. Had the county enjoyed the benefits of effective leadership during the initial financing and refinancing of its sewer debt, the impact of systemic problems in the municipal finance markets might have been avoided or mitigated.³

This paper begins by summarizing how the county's governance structure set the stage for fiscal disaster. Following that, the paper focuses on the systemic problems in municipal finance markets that hastened the county's fiscal implosion and considers possible federal

² December 9, 1996 Decree of the Court in the cases of *Kipp, et al v. Jefferson County*, No. CV-93-G-242-S and *U.S. v. Jefferson County*, No. CV-94-G-2947-S (hereinafter "Sewer Consent Decree").

³ See Landry & McCarty, *supra*, note 1 at 32 (describing how effective leadership could have helped prevent bankruptcy in other municipalities).

responses to address those problems. These systemic issues include: (i) the prevalence of negotiated pricing rather than competitive pricing; (ii) the role of unregulated market participants; (iii) failures in the auction rate security (ARS) and variable rate demand obligation (VRDO) markets; (iv) inadequacies in the municipal disclosure regime; and (v) a lack of transparency in municipal swaps. Where applicable, possible reforms at the federal level to address these issues are suggested.

I. THE ORIGINS OF JEFFERSON COUNTY’S PREDICAMENT

To understand the events that led to Jefferson County’s debt crisis, one must first understand the county’s commission form of government and how that form of governance first facilitated the county’s neglect of its sewer system and then abetted the county’s risky and irresponsible borrowing strategy.

A. COUNTY GOVERNANCE

Jefferson County governs itself through a County Commission form of government, in which legislative, executive and administrative responsibilities are exercised collectively by the County Commission. Commissioners administer these responsibilities through departmental subdivisions, and different departments are responsible for different areas of county services. The county’s form of government is the product of a 1985 federal consent decree stemming from a lawsuit brought under the Voting Rights Act.

Before 1985, the Jefferson County Commission consisted of three at-large members, each of whom was elected by the entire county, and each of whom represented and was accountable to the entire county. This arrangement was challenged on the grounds that it diluted the votes of minority voters, and, in 1985, a federal consent decree changed the structure of the county commission to allow for greater minority representation on the commission. The consent decree

replaced the three-member, at-large commission with a five-member, single-district commission in which commissioners were elected by and represented a single district.

The consent decree provided that “immediately following the 1986 elections, the new five member commission would distribute the powers and duties conferred by law upon the county commission and the members thereof as they deem fit and efficient.”⁴ As the first order of business, the newly elected commissioners divided responsibility for county government among five departments: (1) Department of Finance and General Services; (2) Department of Roads and Transportation; (3) Department of Environmental Services; (4) Department of Health and Human Resources; and (5) Department of Community and Economic Development. Each commissioner individually assumed responsibility for one of these areas.⁵

Because each commissioner represented an individual district, rather than the county as a whole, this arrangement fragmented the administrative responsibility for Jefferson County. Dividing the commissioners’ responsibilities along departmental lines led each commissioner to focus on the narrow, parochial responsibilities of his particular department. Moreover, each commissioner viewed his department’s responsibilities through the prism of electoral self-interest. The four county commissioners who were not directly responsible for the sewer system had no incentive to raise the issue of sewer maintenance; sewer system maintenance was—literally—not their problem. The county commissioner who was responsible for sewer system maintenance also had no incentive to raise the issue; he would be blamed individually for rate increases necessary to pay for repairing the system.

The tendency to avoid action and ignore problems inherent in the single-district system of governance was exacerbated by the fact that not all of the districts were equally served by the

⁴ *Taylor v. Jefferson County Commission*, No. CV-84C-1730-S at 2 (N.D.Ala. Aug. 17, 1985) (consent decree).

⁵ *See Yeldell v. Cooper Green Hospital, Inc.*, 956 F.2d 1056 (11th Cir. 1992) (describing structure of county government).

county's sewer system. Most of the county's high-income residents live in suburbs where septic tanks are common. Commissioners representing these suburban districts would have little incentive to worry about the disrepair into which the sewer system had fallen. By fragmenting responsibility for county-wide problems among individual commissioners, Jefferson County's commission form of government all but guaranteed that the county's sewer system would fall into neglect, necessitating more extensive and more costly repairs at a later date.

B. CLEAN WATER ACT CONSENT DECREE

Years of neglect, sewage backup, and overflows developed into a serious environmental problem, a problem made even worse when other municipalities within Jefferson County connected their sewage facilities to the county's sewer lines. The county's sewage problem resulted in a suit brought under the Clean Water Act against the county. In 1996, the county negotiated a consent decree with the U.S. Environmental Protection Agency, under which the county agreed to correct decades of deferred maintenance within twelve years and to assume responsibility for all sewer lines in the county, many of which were in dire need of repair.⁶

Given the impracticality, if not outright impossibility, of complying with the terms set forth in the consent decree, one can surmise that the commissioners were in "crisis mode" when they accepted the court's mandate. At the time the consent decree was entered into, the local media and editorial pages were pressing for a resolution that would solve the county's sewage problem. Anyone who questioned the financial prudence of agreeing to the terms of the consent decree — no matter how onerous — was pilloried by the press as "pro-pollution" or "anti-environmental."⁷ The local media did not protest the county's acceptance the consent decree, the terms of which were impossible to meet, or the county's risky borrowing to finance an

⁶ Sewer Consent Decree, *supra*, note 2.

⁷ Editorial, *Common Ground: County and Environmentalists Avoid Long Fight with a Sensible Settlement Suit over Raw Sewage Releases*, THE BIRMINGHAM NEWS, Aug. 3, 1995, at 10A

unworkable project.⁸ Accountability and good fiscal management became a concern to the journalists only when the house of cards came down. At the best of times it can be difficult for fragmented governance to produce good policy, but it is doubly difficult when controversial issues erupt.⁹

Notwithstanding the media's militating in favor of a quick settlement, some county officials tried to sound an alarm about the burden that would eventually be borne by the county's rate payers. At the time the county commission accepted the terms of the consent decree, the county's Department of Environmental Services expressed major concerns to the county commissioners about the feasibility of complying with the consent decree without increasing rates exponentially to pay for repairs.¹⁰ These concerns went unheeded. Because no single county official was responsible to the county as a whole, tackling enormous projects like those called for in the consent decree required a level of coordination that was difficult to obtain with the fragmented commission form of government. The entanglement of executive, legislative, and administrative responsibility made oversight of county-wide problems an impossible task.

C. SEWER SYSTEM FINANCING

The County Commission form of government resulted in the county's assumption of an impossible mandate; it also facilitated the county's disastrous foray into the municipal finance market. The cost of the extensive improvements mandated by the consent decree was originally estimated to be around \$1.5 billion. Additional projects and expansions inflated the county's

⁸ See, e.g., Editorial, *Common Ground: County and Environmentalists Avoid Long Fight with a Sensible Settlement Suit over Raw Sewage Releases*, THE BIRMINGHAM NEWS, Aug. 3, 1995, at 10A ; Karin Meadows, *Interest Rate Swap Nets \$3.1 Million for County*, THE BIRMINGHAM NEWS, Dec. 30, 1997, at 1B.

⁹ See, eg, Carol Robinson, *McNair Touts Sewer Plan, Hits Cahaba Advocates Suit*, THE BIRMINGHAM NEWS, May20, 1995, at 5A; Steve Visser, *Lightning Rod: Love Her or Hate Her, Bettye Fine Collins Must Be Reckoned With*, THE BIRMINGHAM NEWS, Nov. 24, 1996, at 1A.

¹⁰ See *Jefferson County Sewer Consent Decree: A Report by Commissioner Jim Carns* (available at <http://www.jimcarns.com/pdfs/execsummary.pdf>).

sewer debt to over \$3 billion. The disparity between the project's estimated and final cost provides yet another example of the unwieldiness inherent in the county's governance structure.

Jefferson County's sewer debt is not a general obligation of the county. Instead, the county's sewer debt is payable solely out of sewer revenues, and not from county taxes or other revenue. Thus, an increase in the amount of sewer debt would result — all other things being equal — in rate increases on the users of the sewer system.

At inception, 95% of the county's sewer debt took the form of long-term fixed rate warrants.¹¹ To obtain lower interest rates, the county refinanced its sewer debt and replaced its fixed rate debt with variable rate debt. Perhaps more importantly, given the political pressure on county commissioners not to raise fees, refinancing the county's debt also permitted the county to avoid the rate increases necessary to fund sewer improvements. After the refinancing, the county was left with \$2.09 billion of auction rate securities, \$951 million of variable rate demand obligations, and \$234 million of traditional fixed rate bonds—a total of about \$3.2 billion.¹²

The refinancing of the sewer debt depended upon highly-rated bond insurers acting as third-party financial guarantors, and all of the sewer debt issuances were guaranteed by bond insurers. These guaranties from bond insurers with high credit ratings increased the market's perception of the credit quality of the county's debt, which provided the county with lower interest rates; the lower interest rates, in turn, permitted the county to avoid raising fees on users of the sewer system.¹³

The interest rate on the auction rate securities was reset weekly through an auction. Existing holders and potential investors were to take part in a competitive bidding procedure.

¹¹ Letter from Commissioner Bettye Fine Collins, President Jefferson County Commission, to Mary L. Schapiro, Chairman U.S. Securities Exchange Commission (June 3, 2009) (available at <http://ftpcontent.worldnow.com/wbrc/docs/collins2009nov4.pdf>) (hereinafter "Collins Letter")

¹² *Id.*

¹³ *Id.*

Buyers specified the number of securities they wished to purchase with the lowest interest rate they were willing to accept. The interest rate paid by the county was set by the lowest bid at which all the securities could be sold at par. If there were too few bids to purchase all the securities, the auction failed and existing investors had to keep their securities. The interest rate would then be set at an alternate rate determined by a formula in the indenture. The designated broker-dealers could act as bidders of last resort and purchase warrants on their own account to prevent the auction from failing.¹⁴

The interest rate on the variable rate demand obligations was also reset weekly, based on market conditions. But, unlike the holders of the auction rate securities, who were compelled to hold their securities if the auction failed, the holders of the VRDOs had the right to tender their securities to a commercial bank on seven days' notice. The terms of the indenture required a stand-by purchase agreement from a commercial bank to secure the payment of the repurchase price upon tendering of the VRDO. If the bank purchased the VRDOs that were tendered to it, the stand-by purchase agreement required the county to retire the variable rate demand warrants over four years rather than thirty. The stand-by purchase agreement also gave the bank the right to terminate the stand-by purchase agreement if the bond insurers that guaranteed the warrants were downgraded below investment grade.¹⁵

The county's debt service was supposed to remain "synthetically fixed" by combining the variable rate debt payments on the bonds with interest rate swaps. The county was to make periodic fixed rate payments to a swap counterparty and to receive periodic variable rate interest payments from the counterparty, based on a percentage of an interest rate index. In theory, this

¹⁴ See, Song Han and Dan Li, *Liquidity Crisis, Runs, and Security Design—Lessons from the Collapse of the Auction Rate Securities Market*, Federal Reserve Board Division of Research and Statistics, Feb. 15, 2008 (available at <http://ssrn.com/abstract=1364732>) (examining systemic risks leading to collapse of ARS market).

¹⁵ Collins Letter, *supra* note 11.

structure was a hedge by which Jefferson County could protect itself against the risk of future rises in interest rates. Because the variable payments received by the county on its interest rate swaps were supposed to offset the variable interest payments made by the county on its sewer warrants, the swap payments to the counterparty should have been the county's only cost—if the swaps worked as planned.¹⁶

At first, the county's refinancing and hedging appeared to have been in the county's interest. Refinancing permitted the county to obtain a lower interest rate, and hedging protected the county against interest rate fluctuations. But with the onset of the recession in 2008, the latent risks in the structure of the county's sewer debt became painfully apparent. The credit ratings of the county's bond insurers were downgraded, which caused the interest rates on the county's auction rate securities and variable rate demand obligations to skyrocket. And central banks cut benchmark borrowing costs to fight the recession, which caused the floating rate payments that the county received under the interest rate swaps to plunge. Terminating these swaps, which had ceased to be an effective hedge, would have cost the county hundreds of millions of dollars. Hence, the instrument meant to protect the county from fluctuations in interest rate movements had become a crippling liability.

D. A PRELIMINARY ASSESSMENT.

Events in the wider financial markets combined with this risky financing structure to produce a fiscal catastrophe for Jefferson County. The county's leadership failed to perceive the perils in its financial engineering, and that failure was the result of poor decision-making brought about by a flawed county governance structure. Looking at the responsibilities of the commissioners, one can easily understand how they could become so immersed in administrative

¹⁶ *Id.*

detail that there was no time for coordinated policy planning. It is difficult for five people to manage efficiently, on a collective basis, a budget of approximately \$809 million while providing varying levels of supervision to about 3,600 employees. The county-commission form of government resulted in the county's adoption of complex programs, like the sewer upgrades and accompanying financing, without fostering a sense of priorities or an appreciation of the long-term consequences.¹⁷

II. SYSTEMIC PROBLEMS IN MUNICIPAL FINANCE MARKETS

While the root causes of Jefferson County's ill-advised borrowing strategy can be traced to the county's fragmented form of governance, the consequences of the county's weak governance were amplified by system-wide problems that plague municipal financial markets as a whole. Two lessons can be drawn from Jefferson County's disastrous foray into the municipal finance markets. First, unregulated, third-party "financial advisors" that advise municipalities on the issuance of bonds or the use of derivatives should be free from conflicts of interest, or at a minimum, fully disclose actual or potential conflicts of interests. Second, municipal issuers should provide more reliable, standardized disclosure to investors, which would help lower issuers' borrowing costs and reduce burdens on taxpayers and ratepayers.

A. BACKGROUND

1. The Market and Its Participants

There are over 55,000 issuers of municipal securities, including towns, cities, counties, and states, as well as other state and local government agencies and authorities—such as

¹⁷ For an interesting study on how to achieve greater efficiency and accountability in county government *see* FRANK J. COPPA, COUNTY GOVERNMENT: A GUIDE TO EFFICIENT AND ACCOUNTABLE GOVERNMENT, Praeger (2000).

hospitals and colleges—that issue securities for special purposes.¹⁸ No other direct capital market has as many borrowers as the municipal finance market, and the sums raised by local governments are often much smaller than those raised by corporations. Local governments use funds tapped from the capital market to pay for projects ranging from bridges and schools to hospital wings and community parks.

Municipal securities have evolved into highly complex structures. Extensive variation in the laws among the fifty states, as well as in local ordinances and codes among the tens of thousands of localities, results in an enormous diversity of financing structures. These variations in regulation affect the authority of local governments to borrow, to lend credit, to impose taxes and special assessments, to enter into contracts related to municipal debt, to budget for debt service, and to conduct other necessary functions.¹⁹

The volume of municipal securities outstanding has multiplied. In 1975, yearly issuance of municipal securities was \$58 billion, mostly in the form of general obligation debt with fixed interest rates and maturities.²⁰ Annual issuance of municipal securities in recent years has averaged \$458 billion and the total principal value outstanding is \$2.7 trillion.²¹ Historically, municipal securities have been considered safe investments, and the major credit rating agencies have conferred investment grade ratings upon municipal debt. In 2002, Moody's Investor

¹⁸ Council of State Governments, Resolution on Rating Agency Reform and Preserving the Tower Amendment, at p. 2 (available at <http://www.csg.org/events/annualmeeting/documents/ResolutionRatingAgencyReformandTowerAmdt.pdf>)

¹⁹ See *Legislative Hearing on Transparency and Regulation of the Municipal Securities Market: Before the Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress (2009) (statement of Ronald A. Stack) at 12 (hereinafter at “Stack Statement”).

²⁰ THE BOND BUYER/THOMSON FINANCIAL 2004 Yearbook at 10.

²¹ Stack Statement, *supra* note 19, at 30-31.

Service concluded that the default rate for investment grade municipal debt over a ten year period was .03% compared to 2.32% for investment grade corporate debt.²²

But these low default rates mask the fact that not all municipal bonds are created equal when it comes to default risk. Municipal bonds are classified as either general obligation bonds (GO bonds) or revenue bonds. When a municipal borrower issues a GO bond, the bond is secured by the full faith, credit, and taxing authority of the municipal borrower. The municipality commits, if necessary, to impose higher taxes on its residents to meet debt service requirements. So long as the issuer has a viable tax base, the likelihood of default is low. Many states, however, limit the total amount of GO debt that their political subdivisions may have outstanding. Alabama is one of these states. Because Jefferson County's sewer debt exceeded Alabama's limit for GO bonds, the county financed its debt through the other major type of municipal obligation—revenue bonds.²³

The debt service on revenue bonds is secured by anticipated user fees from the underlying project being financed. Because revenue bonds are backed by a specific stream of revenue, default risk varies with the strength of the underlying revenue source. If the fees from the underlying projects financed by the revenue bonds turn out to be unpredictable, these bonds can be extremely risky.

Although individual investor participation in the municipal securities market is quite high, the market remains an over-the-counter, dealer market.²⁴ There are no central exchanges,

²² Moody's Rating Service, "Special Comment: Moody's US Municipal Bond Rating Scale" (Nov. 2002), available at <http://www.moodys.com>

²³ Cite AL code.

²⁴ Stack Statement, *supra* note 19, at 13

specialists, or formal market maker designations. Approximately 2,040 securities firms and banks were authorized to act as brokers and dealers in municipal securities at the end of 2008.²⁵

2. Municipal Securities Regulation

Even though individual investor participation in the municipal bond market is quite high, municipal securities are exempted from the registration requirements and civil liability provisions of the Securities Act of 1933 (“Securities Act”),²⁶ and periodic reporting requirements under the Securities Exchange Act of 1934 (“Exchange Act”).²⁷ Transactions in municipal securities are subject to the antifraud provisions of Section 17(a) of the Securities Act,²⁸ Section 10(b) of the Exchange Act,²⁹ and Rule 10b-5.³⁰ These antifraud provisions prohibit any person—including municipal issuers, brokers, dealers and municipal securities dealers—from making a false or misleading statement of material fact, or from omitting any material fact that would make a statement not misleading, in connection with the offer, purchase or sale of any security.³¹ Brokers, dealers, and municipal securities dealers are subject to regulations adopted by the Securities Exchange Commission, including regulations adopted to define and prevent fraud. However, the SEC’s authority to require affirmative disclosure from municipal issuers is limited.

Municipal securities dealers are also subject to rules promulgated by the Municipal Securities Rulemaking Board.³² The MSRB is a self-regulatory organization established by

²⁵ *Id.*

²⁶ Securities Act § 3(a)(2); 15 U.S.C. § 77c.

²⁷ Exchange Act § 3(a)(12)(A)(ii); 15 U.S.C. 78c(a)(12)(A)(ii).

²⁸ 15 U.S.C. § 77q

²⁹ 15 U.S.C. § 78j

³⁰ 17 CFR § 240.10b-5

³¹ *Id.*

³² 15 U.S.C. § 78o-4; Lisa M. Fairchild and Nan S. Ellis, *Rule 15c2-12: A Flawed Regulatory Framework Creates Pitfalls for Municipal Issuers*, 55 WASH. U. J. OF URBAN AND CONTEMPORARY LAW 587, 623 (1999).

Congress in 1975 under Section 15B of the Securities Exchange Act.³³ The MSRB's mission is to develop rules for securities firms and banks that underwrite, trade, and sell municipal securities. Although the Exchange Act provides the MSRB with authority to regulate dealers in connection with their transactions in municipal securities, the MSRB does not have the authority to regulate other participants in the municipal finance market, such as independent financial advisors.

MSRB rules are "principles-based." For instance, MSRB Rule G-17 requires every broker, dealer, and municipal securities dealer, in the conduct of their municipal securities business, to deal fairly with all persons and not to engage in any deceptive, dishonest, or unfair practice. Under the "suitability rule," dealers must have "reasonable grounds" to believe that the securities they market to investors are suitable for those investors. Two particularly important rules are G-37 and G-38, which specifically address pay-to-play issues and the use of paid political operatives to obtain municipal securities business.

The MSRB does not have the authority to enforce its rules. Enforcement authority has instead been given to the Financial Industry Regulatory Authority (FINRA), the SEC, and the federal bank regulators.³⁴

B. NEGOTIATED DEALS AND POTENTIAL CORRUPTION

In negotiated financings, also known as noncompetitive financings, a municipality communicates privately with an underwriter about public financing and negotiates an interest rate and price with the underwriter. By contrast, in a competitive deal, the municipality posts a public notice asking underwriters to put in bids and awards bond work to the bidder who offers

³³ The Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97(codified as amended 15 U.S.C. § 78o-4(b) (2009)).

³⁴ See Lisa M. Fairchild and Nan S. Ellis, *Rule 15c2-12: A Flawed Regulatory Framework Creates Pitfalls for Municipal Issuers*, 55 WASH. U. J. OF URBAN AND CONTEMPORARY LAW 587, 623 (1999).

the lowest costs. Jefferson County has not used competitive financing for more than a decade.³⁵ Jefferson County is not unique in its reliance on negotiated financing; today most municipal debt is sold through negotiated financing.³⁶ In 1978, 54 percent of all municipal bonds were sold through negotiated sales. Today, it is up to 90 percent.³⁷

The increasing prevalence of negotiated financing is troubling because it creates the opportunity for municipal officials and underwriters to strike deals that are not subject to public scrutiny, which increases the municipalities' susceptibility to being overcharged.³⁸ For example, until 2005, underwriting firms often employed former politicians and lobbyists from local markets as consultants to help win municipal bond sales.³⁹ In Jefferson County, politically connected consultants earned over one million dollars for persuading county officials to choose Bank of America as one of the parties to its interest rate swaps.⁴⁰ Even more egregious, J.P. Morgan is alleged to have paid as much as eight million dollars to friends of county commissioners to influence its selection as underwriter and swap provider.⁴¹ The cronyism and bias encouraged by negotiated financings that take place in private are intolerable when local taxpayers are at risk of being overcharged.

Selling debt in private, without requiring competition, has made public officials vulnerable to underwriters' sales pitches. Open and competitive deals, on the other hand, make it more difficult for issuer officials to direct deals to favored parties. Thus, the potential for deal participants to use hidden payments or favors to obtain business is minimized in a competitive deal. Empirical studies have found that political favoritism in municipal bond issuance results in

³⁵ Martin Z. Braun, et al., *The Banks That Fleeced Alabama*, BLOOMBERG MARKETS 52, 54 (September 2005).

³⁶ *Id.*

³⁷ Arthur Levitt, *Taxpayers Fleeced When Leaders Tap Muni Markets: Arthur Levitt*, BLOOMBERG NEWS (Oct. 21, 2009).

³⁸ *Id.*

³⁹ In 2005, the MSRB changed Rule G-38 to an outright ban on broker/dealer use of such consultants.

⁴⁰ Braun et al., *supra* note 35, at 60.

⁴¹ See *infra* note 68-69 and accompanying text.

greater credit risk, higher bond yields, and greater use of external credit enhancement, all of which result in a greater debt service burden for municipalities and taxpayers.⁴²

C. UNREGULATED FINANCIAL ADVISORS

In addition to negotiated financings, the role of unregulated financial advisors also exposes municipalities and taxpayers to potential abuse. Municipal issuers often rely on these unregulated financial advisors. Some issuers rely on unregulated financial advisors for all aspects of a bond transaction, while others employ unregulated financial advisors for more limited purposes.⁴³ Because the precise role of an unregulated financial advisor is determined by the advisor and the issuer hiring the advisor, the duties performed by the unregulated financial advisor can vary widely from deal to deal.

The term “financial advisor” is not defined in municipal securities regulation. MSRB Rule G-23(b) defines a “financial advisory relationship” for brokers, dealers, and municipal securities dealers, but the MSRB Rules are not applicable to financial advisors who are not brokers, dealers, or municipal securities dealers. Independent financial advisors were unregistered in approximately two-thirds, by par amount, of the municipal offerings in 2008 in which such advisors offered assistance. These unregulated financial advisors are not subject to any constraints on “pay-to-play”—the conflict of interest created when participants in the municipal bond underwriting process make contributions to political leaders in exchange for being chosen to participate in future negotiated bond sales. Although the MSRB implemented rules to prevent broker-dealers from making such political contributions in 1994, those rules do not apply to unregulated financial advisors.⁴⁴

⁴² Alexander W. Butler, et al., *Corruption, Political Connections, and Municipal Finance*, AFA 2008 New Orleans Meeting Paper (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=972471&download=yes).

⁴³ See, e.g., *In Matter of Public Finance Consultants, Inc., et al.*, Sec. File No. 3-11465 (Feb. 25, 2005).

⁴⁴ MSRB Rule G-37

Unregulated financial advisors have significant influence on issuers and earn significant fees from arranging bond issuances and swaps. A truly knowledgeable and disinterested advisor can help guide issuers through the regulatory and financial complexity of issuing their bonds. Ideally, these advisors are independent—without connection to dealers or underwriters—and can preclude dealers or underwriters from being selected if the advisors determine that the underwriting charges are too high, bond terms are unfavorable to the issuer, or the underwriter’s services are inadequate.

But if advisors are not subject to a strictly imposed fiduciary duty, they may fall prey to perverse incentives. For instance, a financial advisor might advise an issuer to structure an offering in a particular way, even though that structure is not in the issuer’s best interest, because the financial advisor receives payments from a third party, such as the provider of a swap or guaranteed investment contract.⁴⁵

Regulators have grown increasingly concerned about the role of unregulated advisors in the sale of derivative products to municipalities, particularly interest rate swaps.⁴⁶ Derivative products carry numerous embedded risks that may not be easily understood by less sophisticated issuers, such as interest rate risk,⁴⁷ termination risk,⁴⁸ and counterparty risk.⁴⁹ Recent market conditions in which municipalities found themselves losing millions of dollars on interest rate swaps—and were unable to exit these swaps without paying exorbitant termination fees—

⁴⁵ See *Legislative Proposals to Improve the Efficiency of Oversight of Municipal Finance: Hearing H.R. 2549 Before the House Committee on Financial Services*, 111th Cong. (2009) (statement of Martha Mahan Haines).

⁴⁶ See *Legislative Hearing on Transparency and Regulation of the Municipal Securities Market: Before the Senate Committee on Banking, Housing, and Urban Affairs*, 111th Congress (2009) (statement of Ronald A. Stack) at 30-31.

⁴⁷ In Jefferson County’s case, interest rate risk means the risk of a mismatch in interest payments received from the swap counterparty and the interest payments owing on the outstanding sewer bonds. .

⁴⁸ Termination risk means the risk that a counterparty may face a large termination fee to exit a swap that is unfavorable.

⁴⁹ Counterparty risk is the risk that a counterparty will default when suffering large actual or potential losses on its position. Such a default would mean that the other counterparty would have to go to the market to replace its contract at less favorable terms.

highlight this concern. Even many sophisticated issuers face large swap termination fees due to changes in short term interest rates. Jefferson County itself faced a swap termination fee of \$647 million.⁵⁰ The extent to which many issuers have underestimated the potential termination fees associated with interest rate swaps is disturbing, and raises questions about the failure of financial advisors to warn municipalities about these embedded risks.

Within the scope of their employment, independent financial advisors to municipalities should be bound by the highest duties of care and loyalty to the municipal issuers they advise. The municipal officials who engage an advisor are themselves fiduciaries. They are bound to the population of the municipality; the money they raise and spend belongs to the people in the municipality. Hence, these municipal officials are under an obligation to use the funds they borrow for the benefit of residents and to receive the best advisory services for the least amount of cost. These obligations mean that leaders must select the advisors who are most trustworthy and qualified.⁵¹

At a minimum, there should be a wall of separation between financial advisors providing services to a municipality and the municipality's counterparties in derivative transactions. Currently, advisors are often paid by the municipality's swap counterparty, which creates at least the appearance of a conflict of interest. When the financial advisor is paid by both the municipality and the counterparty, it is impossible to determine conclusively whether the financial advisor is representing the interests of the municipality or the swap counterparty. Because the fees that financial advisors receive depend on concluding a swap agreement, a

⁵⁰ Martin Z. Braun & William Selway, *JPMorgan Ends SEC Alabama Swap Probe for \$722 Million*, BLOOMBERG NEWS (November 4, 2009).

⁵¹ See Tamar Frankel, "Let Me Advise You How Much to Pay Me:" *Subverting Fiduciary Duties and Rules*, 28 MUNICIPAL FIN. J. 53, 60 (2007).

strong temptation exists for financial advisors to market swaps by emphasizing the benefits of the swaps and minimizing the risks.⁵²

All financial advisors should be held to minimum standards of conduct that protect issuers, taxpayers, and investors. Rules should be established to achieve the following: (i) prohibit fraudulent and manipulative practices; (ii) restrict real and perceived conflicts of interest; (iii) ensure rigorous standards of professional qualification; and (iv) promote market efficiencies. Preventing manipulative practices and eradicating conflicts of interest are necessary steps for ensuring that financial advisors protect their municipal clients from taking on excessive and inappropriate risks.

D. A TOXIC MIX: RATING AGENCIES, BOND INSURERS, AUCTION RATE SECURITIES AND VARIABLE RATE DEMAND OBLIGATIONS

1. Auction Rate Securities and Variable Rate Demand Obligations

Because short-term interest rates have historically been lower than long-term rates, many municipal borrowers issue bonds with an interest rate that periodically resets. In other cases, municipalities issue variable rate bonds and use swaps to convert their variable rate borrowing to a net fixed interest rate. Jefferson County used this strategy to ill effect.

Auction rate securities (ARS) and variable rate demand obligations (VRDOs) have been the most prevalent form of variable rate borrowing used during the past two decades. With ARS, investors' ability to sell their securities at par depends on the success of a periodic auction process. With VRDOs, issuers offer investors the opportunity to sell their securities at par through a designated "remarketing agent." But unlike ARS, if there are insufficient buyers to

⁵² See *A Special Investigation of the Bethlehem Area School District: A Case Study of the Use of Qualified Interest Rate Management Agreements ("Swaps") by Local Government Units in Pennsylvania, with Recommendations*, November 2009, pg. 42-43 (relating conclusions and recommendations regarding deceptive tactics of market advisors).

cover all VRDO offers, investors have the right to tender their securities to a third-party liquidity-provider. Banks typically act as third-party liquidity providers under standby purchase agreements obligating them to purchase, at par, any VRDOs that cannot be resold through the remarketing process. The interest rate paid by the issuer when the VRDO is tendered to the liquidity provider increases to a pre-determined maximum. After some defined period, usually 90 days, VRDOs put back to the bank—called “bank bonds”—require accelerated amortization.⁵³

2. Bond Insurers: Only as Good as Their Credit Ratings

One of the factors that determine the interest rate paid by municipalities on bonds they issue is default risk. The greater the risk that the municipality will default on the bond, the higher the interest rate it must pay investors to compensate them for that risk. To lower the risk of default, the municipal finance markets have turned to bond insurers, which guarantee repayment of the bonds in exchange for premiums. Before the financial crisis, most of these bond insurers were rated triple-A by the major credit rating agencies. By wrapping their bonds with a guaranty from a triple-A rated insurer, municipalities were able to transfer the insurer’s rating to the municipal bond. Municipalities were thus able to rent the balance-sheet strength of the bond insurer—and the bond insurer’s investment-grade credit rating—in exchange for a premium. By transmuting their bonds into investment grade quality through this balance-sheet alchemy, municipalities lowered their borrowing costs.⁵⁴ This credit rating magic, however, depended upon misdirection and prestidigitation: rather than rating the underlying municipal bonds, the credit rating agencies instead relied on both the balance-sheet strength of the bond

⁵³ See *Legislative Proposals to Improve the Efficiency of Oversight of Municipal Finance: Hearing on H.R. 2549 Before the House Committee on Financial Services*, 111th Cong. (2009) (statement of Michael J. Marz).

⁵⁴ *Legislative Proposals to Improve the Efficiency of Oversight of Municipal Finance: Hearing on H.R. 2549 Before the House Committee on Financial Services*, 111th Cong. (2009) (statement of David W. Wilcox).

insurers as well as the bond insurer's underwriting to assess the creditworthiness of the municipal issuers.

As long as the bond insurers maintained the robustness of their balance sheets, the arrangement worked well. But bond insurer's balance-sheet impregnability proved short lived. Beginning in 2000, the bond insurers diversified their business beyond providing insurance against bond defaults to providing guarantees for collateralized debt obligations (CDOs) and securitizations of various asset classes that were built from subprime mortgages.⁵⁵ As financial markets became aware of the risks associated with subprime mortgages and their securitization, the rating agencies required the bond insurers to increase the cash reserves they held against asset-backed securities that were increasingly perceived as risky. Because the bond insurers had failed to anticipate losses resulting from plummeting house prices and the effect of those losses on their liabilities, they were not prepared to respond to the rating agencies' calls for greater cash reserves. As losses materialized and the bond insurers were unable to satisfy the increased reserve requirements, the credit rating agencies downgraded them rapidly.⁵⁶

When the bond insurers that had guaranteed Jefferson County's bonds lost their triple-A credit ratings, the bonds also lost their high ratings, and investors shunned the bonds because they were no longer perceived as safe investments. Bids for the auction rate warrants dried up, and the broker-dealers were no longer willing to act as bidders of last resort to keep the auctions from failing. When the auctions failed, holders of the ARS could not liquidate their investments, and interest rates on the ARS soared. The declining credit-worthiness of the bond insurers also

⁵⁵ See, e.g. PMI Group Form 10-K filed March 11, 2005 at 85 (In 2004, FGIC, the bond insurer guaranteeing the majority of Jefferson County's debt, began to execute upon its business plan of expanding into new markets and broadening its presence in existing ones. In 2004, FGIC, on a selective basis, broadened its presence in the U.S. public finance area to include such sectors as health care institutions, municipal electric utilities, and investor owned utilities. Also in 2004, FGIC began to broaden its presence in the structured finance market to include classes of consumer-based and investment-grade corporate asset-backed securities, in addition to its established product lines within the mortgage-backed securities sector.)

⁵⁶ See Martin Z. Braun, *Bond Insurance Turns Toxic for Munis as Rates Soar*, BLOOMBERG NEWS (Feb. 11, 2008).

affected the VRDOs. Many holders of VRDOs tendered their bonds to the remarketing agent when the bond insurers that had guaranteed the VRDOs had their credit ratings downgraded.⁵⁷

Among the investors that beat a hasty retreat from the county's bonds were money market mutual funds. Money market mutual funds were compelled to dump their VRDO holdings because Investment Company Act Rule 2a-7 requires them to invest in short-term securities with minimal risk; VRDOs met that objective so long as they had a triple-A credit rating.⁵⁸ But when the ratings agencies downgraded the bond insurers, the VRDOs lost their status as eligible investments for money market funds and the money market funds "put" the VRDOs back to the banks, who soon discovered that the VRDOs could not be remarketed to other funds.⁵⁹

With no new investors to buy the VRDOs, the banks were obliged to purchase all the VRDOs under the stand-by purchase agreements. The banks' purchase of the VRDOs under the stand-by purchase agreement in turn accelerated the amortization schedule on all \$850 million of the country's VRDOs, requiring Jefferson County to fully repay its debt in four years instead of thirty.

3. What to Do About Bond Insurers and Rating Agencies?

At its height in the early 2000s, the municipal bond insurers guaranteed more than half of all municipal bond offerings. Now that share is only 10%. Two years ago the market for bond

⁵⁷ *Id.*

⁵⁸ 17 CFR § 270.2a-7; Under Rule 2a-7, money market mutual funds (MMMFs) must meet strict portfolio quality, diversification, and maturity standards which are meant to limit the possibility of significant deviation between the share price of a fund and its per share asset value. MMMFs are limited to investing only in securities placed by at least two NRSROs in one of the two highest short-term rating categories. Also, MMMFs generally may not acquire any instrument having an remaining maturity of greater than 397 days and may not maintain a dollar-weighted average portfolio maturity of more than 90 days. The purpose of the maturity provisions is to limit the exposure of MMMFs to interest rate risk.

⁵⁹ See *Legislative Proposals to Improve the Efficiency of Oversight of Municipal Finance: Hearing on H.R. 2549 Before the House Committee on Financial Services*, 111th Cong. (2009) (statement of Mary Jo Ochson).

insurance had seven viable players; today only one company is writing business.⁶⁰ As a result of this contraction, low-rated municipal issuers attempting to refinance have been unable to find guarantors for their municipal debt.⁶¹

Some have suggested that the collapse of the municipal bond insurance market can be addressed through temporary reinsurance provided by the federal government for municipal bonds covered by a primary policy from a private bond insurer.⁶² Under this proposal, the U.S. Treasury would offer \$50 billion of reinsurance to bond insurers and charge them risk-based premiums in return for this coverage. After the financial markets have stabilized, the reinsurance program would be privatized. Although such a program could benefit troubled municipal issuers in the short term, fiscal conservatives are dubious about extending yet more federal guaranties to private market participants.

Others have suggested that it would be preferable to restore confidence in the bond insurance market through long-term reforms aimed at making the bond insurance market more transparent and stable. Disclosure-based reforms would restore confidence in the bond market while avoiding moral hazard and the risk that taxpayers would be left holding the bag in a federal reinsurance program.

Currently, third-party financial guaranties of municipal bonds are not regulated under the federal securities laws. Given the crucial roles that third-party financial guaranties play in the municipal securities market, more comprehensive disclosure about the companies offering such guaranties would be useful. One way to ensure better disclosure would be to require ongoing

⁶⁰ *Viewpoint: Revitalize Muni Bond Insurance Market*, AMERICAN BANKER, Oct. 28, 2009.

⁶¹ *See Legislative Proposals to Improve the Efficiency of Oversight of Municipal Finance: Hearing on H.R. 2589 Before the House Committee on Financial Services*, 111th Cong. (2009) (statement of Bernard Beal).

⁶² H.R. 2589, 111th Cong. (2009)

shelf-registration for entities that offer third-party financial guaranties for municipal securities.⁶³

The annual registration statements of the bond insurer would then be incorporated into the official disclosure statements for the municipal security guaranteed by that bond insurance company. This increased disclosure would give investors the information they need to enforce market discipline on the bond insurers.

Reforming the practices of credit rating agencies is an important task in encouraging transparency and market discipline. There were two separate but interrelated errors in judgment on the part of the credit rating agencies. First, the rating agencies had been free-riding on the bond insurers' assessments of the financial stability of municipal issuers. The rating agencies believed that if the bond insurers had already signed off on the municipality's credit worthiness by insuring the municipal issuance, then there was little point in the agencies' independent evaluation of the issuance. This state of affairs might have continued unnoticed but for the rating firms' second great blunder; they also failed to recognize the bond insurers' exposure to securitized assets cobbled together from subprime mortgages.

The magnitude of the effect that ratings downgrades of bond insurers had on municipal securities suggests the need for more meaningful disclosure of ratings criteria, especially for the criteria used to rate complex structured securities. The Credit Rating Agency Reform Act of 2006,⁶⁴ which required that credit rating agencies seeking "nationally recognized statistical rating organization" (NRSRO) status register with the SEC, was a halting step towards greater ratings transparency. However, the Act requires that only general information about the agencies' rating methodology be given to the public. Congress did not require greater disclosure out of concern

⁶³ Jeffrey A. Nemecek, *Municipal Securities and Financial Institutions: Proposals for Reform*, 30 MUNICIPAL FINANCE JOURNAL 61, 65 (Spring 2009)

⁶⁴ Pub. L. 109-291, 120 Stat. 1327 (codified 15 U.S.C. § 78o-7 note)

that full disclosure of ratings criteria might compromise proprietary models.⁶⁵ But this solicitude about proprietary models notwithstanding, providing only general information about rating methodologies will not provide the investing public with sufficient data to evaluate the agencies' procedures and methodologies.

Instead, Congress should require that actual rating procedures and methods for specific types of securities be made available to the investing public. The lack of transparency for complex financial products and the companies that insured them was a major contributor to the crisis in the municipal securities markets.⁶⁶ Only through full transparency of the ratings criteria can public confidence in credit ratings be restored. Full disclosure and public evaluation will provide market discipline in the ratings process and minimize reliance on shaky ratings criteria.

E. LACK OF TRANSPARENCY IN MUNICIPAL SWAPS

As the ARS and VRDO markets became distressed, many municipalities, including Jefferson County, faced further pressure because the interest rate swaps that the county bought to hedge against rising borrowing costs completely backfired. It turns out that the “synthetic fixed rate” that the swaps were supposed to achieve were only “fixed” so long as market conditions behaved in a certain way.

When the insurance companies guaranteeing the county's debt lost their AAA credit ratings, and investors shunned those insured securities, interest rates on the warrants exploded. But the floating rate payments that the county received under the interest rate swaps plunged at the same time, as central banks cut benchmark borrowing costs to counter the financial crisis. Jefferson County's swap transaction demonstrates the risk that municipalities take when they

⁶⁵ See Jeffrey A. Nemecek, *Municipal Securities and Financial Institutions: Proposals for Reform*, 30 MUNICIPAL FINANCE JOURNAL 61, 77 (Spring 2009) (“The SEC Release No. 34-55858 specifically cites this policy of restricting public access to ratings criteria, in part, to ‘avoid the disclosure of proprietary information’ and to avoid the disclosure of ‘proprietary models.’”).

⁶⁶ *Id.* at 68.

gamble on interest rate spreads. The county's financial advisors should have warned county officials about the risks of hedging with swaps; clearly they did not.

There is, in fact, a growing perception that banks and advisors conspired to overcharge local governments on derivatives. As already discussed, issuer officials may not be well-served by supposedly independent advisers who receive kickbacks from the banks selling the deals.⁶⁷ But issuer officials themselves have also been implicated in scheming to overcharge on swaps. For example, the SEC has alleged that the chief underwriter and swap provider in Jefferson County's 2002 and 2003 refinancings, JPMorgan, made undisclosed payments to local broker-dealer firms whose owners were friends of county officials in order to enlist the local firm's "political support" for the county's hiring of JPMorgan. The payments may have totaled up to eight million dollars.⁶⁸ The SEC alleged that JP Morgan passed the cost of these payments on to the county by charging higher interest rates on swap transactions. Without admitting or denying the SEC's allegations, JP Morgan has agreed to forfeit the \$647 million the county would have had to pay to terminate the swaps.⁶⁹

It is estimated that Jefferson County overpaid by \$100 million for its swaps, based on prevailing rates at the time.⁷⁰ Overpricing is difficult to detect because the fees charged by swap providers are not obvious to issuer officials (or anyone else for that matter); these fees are built into the swap interest rates. The swap provider charges a "spread fee"—the difference between mid-market interest rates observed at the time of pricing and the rates finally agreed to by the counterparties. This spread is what the swap provider earns on the transaction. The banks that act as swap providers use complex mathematical models, based on present values at the exact

⁶⁷ See Martin Z. Braun and William Selway, *Hidden Swap Fees by JPMorgan, Morgan Stanley Hit School Boards*, BLOOMBERG NEWS (Feb. 1, 2008).

⁶⁸ *SEC v. LeCroy, et al.*, CV-09-U-2238-S (N.D. Ala. filed Nov. 4, 2009).

⁶⁹ *In the Matter of J.P.Morgan Securities Inc.*, SEC Release No. 9078 (November 4, 2009).

⁷⁰ Ken Wells, *Armageddon in Alabama Proves Parable for Local U.S. Governments*, BLOOMBERG, (Oct. 19, 2009).

moment of pricing as well as other variables, to calculate the spread fee.⁷¹ Without independent advice, issuers cannot be sure that these fees have been fairly calculated because issuers cannot easily evaluate the terms of their swaps against comparable ones done by other municipalities.⁷²

Churning—entering into multiple swaps against a single bond issuance in order to make more fees—is another problem that affects the sale of derivatives transactions in the municipal finance market. Jefferson County appears to have been a victim of churning. When entering into interest rate swaps, municipalities typically match the notional value underlying the swap to the amount of the debt to be hedged. Jefferson County, however, had swaps valued at a notional \$5.4 billion, but its debt was only \$3.2 billion. While swapping interest payments on \$3.2 billion of debt would lock in a fixed cost for the county’s borrowing, the only conceivable purpose of exchanging interest payments on an additional \$2.2 billion would be to profit from rising future interest rates. The county’s swapping interest payments on the \$2.2 billion was akin to purchasing fire insurance on a building one does not own and then hoping the building goes up in flames.⁷³

The current regulatory regime does not address the problems posed by the sale of derivatives to municipal issuers. Interest rate swaps entered into by municipalities are treated as private transactions between two counterparties, not subject to regulation under the current rules.⁷⁴ The SEC does not have the authority to impose or enforce rules, standards, or disclosure

⁷¹ See *A Special Investigation of the Bethlehem Area School District: A Case Study of the Use of Qualified Interest Rate Management Agreements (“Swaps”) by Local Government Unites in Pennsylvania, with Recommendations*, November 2009, pg. 33-35 (relating information obtained on interviews with school district financial advisors).

⁷² *Id.*

⁷³ Craig Karmin & Liz Rappaport, *How Jefferson County Got Crunched; Strategy to Cut Costs Instead Amplified Risk; Smart Move or Gamble?*, WALL STREET JOURNAL, March 7, 2008, at C.1.

⁷⁴ See Commodity Futures Modernization Act of 2000, Pub. L. 106-554, § 1(a), 114 Stat. 2763, 2763-A, as amended (codified 7 U.S.C. § 5 *et seq.*) (“CFMA”). The CFMA expressly made swaps and other over-the-counter derivative transactions not subject to the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.*, and declared that federal law would

requirements to prevent fraud in any kind of swap agreement.⁷⁵ However, “security-based swap agreements” are subject to the anti-fraud, anti-manipulation, and insider trading provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act. A “security-based swap agreement” is defined in Section 206B of Gramm-Leach-Bliley Act as a swap agreement “of which a material term is based on the price, yield or volatility of any security, or group or index of securities, or any interest therein.”⁷⁶

In 2008, the SEC filed an action involving municipal swap contracts in *SEC v. Langford* asserting its jurisdiction over swaps for the first time. The SEC argued that interest rate swaps based on the Securities Industry and Financial Markets Association Municipal Swap Index are security-based swap agreements and, therefore, subject to the antifraud provisions of the federal securities laws.⁷⁷ The SEC brought this case over objections by industry groups that the interest rate swaps were not security-based swap agreements and, thus, were not subject to the SEC’s jurisdiction.⁷⁸

“preempt the field” of the regulation of the use of derivatives. See Lynn A. Stout, *Regulate OTC Derivatives by Deregulating Them*, 32 REGULATION 30 (2009).

⁷⁵ Securities Act Section 2A(b); Exchange Act Section 3A(b).

⁷⁶ See 15 U.S.C. § 78c definitions.

⁷⁷ *SEC v. Langford, et al.*, CV-08-B-0761-S (N.D. Ala. filed Aug. 7, 2008). (The court has jurisdiction in connection with the swap agreements because they were security based swap agreements. Security-based swap agreements are defined in Section 206B of the Gramm-Leach-Bliley Act, as amended by the Commodity Futures Modernization Act of 2000, as agreements “of which a material term is based on the price yield, value, or volatility of any security or group of securities, or any interest therein.” The terms of the swap agreements stated the County was entitled to receive floating interest rate payments from JPMorgan Chase Bank based in part on the value of the Bond Market Association’s (“BMA”) Municipal Swap Index, an index of securities used to establish the floating rate yield (the Bond Market Association is now known as the Securities Industry and Financial Markets Association). Thus, the transactions constituted security-based swap agreements because a material term in each agreement was based on “price, yield, value, or volatility of any security or any group or index of securities, or any interest therein.”)

⁷⁸ Brief for SIFMA as Amici Curiae Supporting Respondents, *Langford, et al.*, No. CV-08-0761-S (N.D. Ala. filed Aug. 7, 2008). (The CFMA [Commodity Futures Modernization Act] amendments to the Securities Act and the Exchange Act did provide that “security-based swap agreements,” while not securities, are nevertheless subject to the anti-fraud, anti-manipulation, insider trading and short-swing profit provisions of the Securities Act and the Exchange Act. In contrast “non security based swap agreements” are not subject to the anti-fraud, anti-manipulation, insider trading or short-swing profit provisions of these statutes. To distinguish between the two types of swap agreements, the statute defines a “security-based swap agreement” as an agreement “of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any

If the swaps that Jefferson County entered into are not security-based swaps, then they are not subject to the anti-fraud rules against misleading or manipulative practices. Furthermore, such swaps may not be subject to the MSRB's rulemaking authority by-way of Exchange Act Section 15B(c)(1).⁷⁹ Section 15B limits the scope of MSRB rules to transactions in municipal securities—a category of transactions which would include neither security-based swaps nor non-security based swaps.

The *Langford* litigation highlights the confusion that exists over the jurisdictional status of swaps and securities-based swaps. It is for Congress to clarify that confusion. Congress should empower the MSRB to adopt, and the SEC to enforce, protective market-conduct rules that would regulate the sale of over-the-counter (OTC) derivatives to municipalities. These market conduct rules should help ensure that municipalities participating in the OTC derivatives market understand the benefits and risk of doing so.⁸⁰

Even if Congress clarifies that the sale of swaps are subject to market-conduct rules, to ensure that municipalities better understand the transactions they are entering into, there still remains the problem of termination risk, which is the risk that one of the counterparties may be forced to pay a large termination fee to exit a swap that is unfavorable. When a municipality wishes to exit an unfavorable swap, it has to pay its current liability from the contract to the

interest therein.” *[H]owever, swap agreements under which payments are based on the SIFMA Swap Index are not “security-based swap agreements.”* First the SIFMA Swap Index is an *index of interest rates*, not an “index of securities.” Second, a swap agreement under which payments are based on the SIFMA Swap Index is not based on “the price yield, value, or volatility of any security or any group or index of securities.” [T]he court should reject the SEC’s erroneous attempt to assert claims involving non-security based swap agreements.)

⁷⁹ 15 U.S.C. § 78o-4(c)(1) (No broker, dealer, or municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the [Municipal Securities Rulemaking] Board.)

⁸⁰ Such business conduct rules would, among other things, require disclosure of: (i) information about the material risks and characteristics of the swap; (ii) the source and amount of any fees or other material remuneration that the swap dealer and swap advisor would directly or indirectly expect to receive in connection with the swap; and (iii) any other material incentives or conflicts of interest that the swap dealer or swap advisor may have in connection with the swap.

counterparty. If the municipality's termination fee is too expensive, it has to stick with the swap arrangement and keep paying interest rates that are disadvantageous. To preclude such a miserable situation, Congress could require municipalities to obtain insurance against financial risks that may arise when a swap is terminated.

There are at two advantages to this proposal. First, this kind of "swap termination" insurance can provide a stressed municipal issuer with the necessary funding to exit a swap agreement. Second, and more importantly, requiring this kind of insurance may prevent municipalities from entering into overly risky swaps in the first place. Lack of financial sophistication and poor negotiation on the part of municipal officials may leave a municipality exposed to considerable risk of termination payments. Requiring insurance protection would force a municipality to quantify *ex ante*, through premium payments, the risk of early termination of the swap. If the municipality cannot negotiate a swap contract that avoids a substantial risk of early termination, insurance will be prohibitively expensive and the municipality will be deterred from entering into the disadvantageous swap arrangement.⁸¹

E. THE CONFUSING NATURE OF THE MUNICIPAL DISCLOSURE REGIME

1. Why Municipal Securities Differ from Other Securities.

Retail investors in the municipal market do not enjoy the same transparency readily available in corporate debt or securities markets. Many of the problems in the municipal financial crisis stemmed from inadequate disclosure about risks associated with products and market participants, such as liquidity problems facing municipal ARS and the ratings downgrades of municipal bond insurers. Yet the securities laws do not mandate disclosure

⁸¹ See Alexander Buchanan, *Dealing with Municipal Swap Risks*, 26 MUNICIPAL FINANCE JOURNAL 36, 43-43 (2005).

about these kinds of risk multipliers.⁸² The regulatory framework could be amended to provide investors with better information.⁸³ One prominent market participant has described the disclosure that state and local governments provide to investors as being in the “dark ages.”⁸⁴

Federal securities regulation is disclosure based, and issuers of securities are responsible for the disclosure.⁸⁵ Municipal securities regulation differs, however, because, unlike other issuers, municipalities have no shareholders and are not managed to produce profits. Rather, municipalities are managed for the benefit of their constituents and only incidentally to pay those investors who purchase their debt. Nonetheless, disclosure and transparency in the municipal markets are important for the protection of tax and rate payers. Poor disclosure and lack of transparency about municipal bonds result in higher debt service payments for municipal issuers, which in turn results in higher taxes and rates that are passed on to residents of the municipality. Municipal investors demand higher returns because of the elevated risks that come with lack of information due to slipshod disclosure practices.⁸⁶ Better disclosure removes some of the risk stemming from uncertainty, and should lower the interest rates municipalities pay on their debt.

2. The Limited Powers of the SEC and MSRB over Municipal Securities.

Although the SEC is authorized to take enforcement action against issuers of municipal securities that violate the antifraud provisions of the federal securities laws, it cannot require

⁸² The securities laws focus mainly on disclosures about the issuer itself and the behavior of underwriters and broker-dealers; these laws are not geared towards disclosure of risk inherent in the structure the transaction (e.g. liquidity risk with ARS, interest rate risk with derivatives). See Jeffrey A. Nemecek, *Municipal Securities and Financial Institutions: Proposals for Reform*, 30 MUNICIPAL FINANCE JOURNAL 61, 68 (Spring 2009).

⁸³ See *Testimony Concerning Enhancing Investor Protection and Regulation of the Securities Markets: Before Senate Committee on Banking, Housing, and Urban Affairs*, 111th Cong (2009) (Statement of Mary L. Schapiro, Chairman, Securities and Exchange Commission).

⁸⁴ Darrell Preston, *Governments never in Default Pay More Interest Than Companies*, BLOOMBERG (Oct. 28, 2009).

⁸⁵ Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Speech by SEC Chairman: Integrity in the Municipal Market (July 18, 2007) [hereinafter Cox Speech], available at <http://www.sec.gov/news/speech/2007/spch071807cc.htm>.

⁸⁶ Arthur Levitt, *Taxpayers Fleeced When Leaders Tap Muni Markets: Arthur Levitt*, BLOOMBERG NEWS (Oct. 21, 2009).

affirmative disclosure from municipal issuers.⁸⁷ Federal regulatory forbearance in municipal securities can be attributed to an issue as old as the Republic itself: federal versus state sovereignty. To reinforce the concept of intergovernmental comity, both the SEC and MSRB are prohibited from requiring issuers of municipal securities to file registration documents before municipal securities are sold. This prohibition, codified in Exchange Act Section 15B(d), is known as the “Tower Amendment,” after Senator John Tower,⁸⁸ and forms the structural foundation of the municipal securities regulatory scheme. It provides as follows:

(1) Neither the [SEC] nor the [MSRB] is authorized under this title, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer [i.e. an underwriter of an offering of municipal securities], to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities; (2) The Board is not authorized under this title to require any issuer of municipal securities, directly or indirectly through a municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer.⁸⁹

Given the strictures of the Tower Amendment, the SEC and MSRB can impose disclosure requirements only on municipal securities brokers and dealers. To the extent that municipalities can be compelled to disclose information to investors, that disclosure comes about indirectly, by means of the antifraud provisions of the securities laws, which are applicable to municipal issuers.⁹⁰ Although the SEC has brought enforcement actions in a number of high profile cases

⁸⁷ Andrew Ackerman, *Haines: SEC Can't Set Up Corporate-Style Disclosure Regime for Munis*, THE BOND BUYER (Oct. 9, 2009).

⁸⁸ John Goodwin Tower: Biography, Biographical Directory of the United States Congress 1774 to Present, <http://bioguide.congress.gov/scripts/biodisplay.pl?index=T000322>.

⁸⁹ 15 U.S.C. § 78o-4(d)(1)-(2)

⁹⁰ See Ann Judith Gellis, *Municipal Securities Market: Same Problems—No Solutions*, 21 DEL. J. CORP. L. 427, 433 (1996).

in recent years,⁹¹ it is not currently able to address *ex ante* the disclosure problems exposed by those enforcement actions against municipal issuers.⁹²

3. Indirect Disclosure

While the Tower Amendment prohibits the SEC from imposing disclosure requirements directly on municipal issuers, the Exchange Act grants the SEC regulatory authority over brokers and dealers who underwrite issuances of municipal securities or otherwise engage in municipal securities transactions. Exchange Act Section 15(c)(2) grants authority to the SEC “[t]o define and prescribe means reasonably designed to prevent” fraudulent, deceptive, or manipulative acts and practices, and fictitious quotations by brokers and dealers. Pursuant to that authority, the SEC adopted Rule 15c2-12 to improve transparency in the municipal markets.⁹³ The rule indirectly results in initial disclosure, periodic disclosure, and secondary market reporting from municipal issuers by requiring underwriters that participate in an offering of municipal securities to obtain the agreement of the issuer to make those disclosures. More specifically the rule requires participating underwriters purchasing or selling municipal securities in primary offerings to reasonably determine that an issuer will undertake to make disclosure statements available to investors. As a result, new underwriters in primary offerings must obtain, review, and distribute copies of the issuer’s Official Statement. The Official Statement is analogous to the prospectus distributed prior to corporate issuances and contains all information “material” to the bond issue. The participating underwriter must also determine that the issuer has undertaken to make certain continuing disclosures annually and on the occurrence of certain material events

⁹¹ See, e.g., *In the Matter of the City of San Diego*, SEC Release No. 34-54745 (Nov. 14, 2006); *In the Matter of the City of Miami, Florida*, SEC Release No. 34-47552 (Mar. 21, 2003).

⁹² See *Disclosure and Accounting Practices in Municipal Securities Markets*, Securities and Exchange Commission, White Paper to Congress, July 2007 (available at <http://www.sec.gov/news/press/2007/2007-148wp.pdf>).

⁹³ 17 C.F.R. 240.15c2-12.

to the MSRB's Electronic Municipal Market Access system.⁹⁴ Thus, the SEC is able to force disclosure from municipal issuers, albeit in a round-about way.

But these indirect measures to force transparency have failed to keep pace with the extraordinary growth and increasing complexity of the municipal bond industry. Complex debt instruments today contain new kinds of risk—risks that were not present in 1975 when the Tower Amendment was passed.⁹⁵ Nonetheless, the SEC and MSRB have tried to keep up with the market's added complexities. Indeed, the SEC has recognized the need to modify Rule 15c2-12 as a result of the changing municipal securities market. For instance, VRDOs are currently exempted from Rule 15c2-12's continuing disclosure requirements, notwithstanding that VRDOs accounted for 38% of municipal trading volume in 2008. The SEC has proposed amendments to the regulation that would eliminate this exemption for VRDOs.⁹⁶ The MSRB has also taken action that should enhance transparency in ARS and VRDOs, the hardest hit sectors of municipal finance. The MSRB has proposed amendments to Rule G-34(c) that would require ARS "Program Dealers" to disclose "ARS bidding information" for orders placed by an ARS Program Dealer.⁹⁷ Requiring disclosure of dealer orders will provide the market with information about how the interest rates are determined in a successful auction and the extent to which the auction's success is dependent on dealer bids. Participants in the municipal ARS markets will be able to calculate "bid-to-cover ratios," similar to Treasury auctions, that would indicate the liquidity of ARS in particular auctions. In addition, the MSRB rule amendment would require the VRDO remarketing agent to report the identity of all liquidity providers for VRDOs. This amendment

⁹⁴ Cite 15c2-12 here; See Lisa M. Fairchild & Timothy W. Koch, "Municipal Securities," chapter 6 in the *Handbook of Modern Finance*, edited by Dennis Logue and James Seward, Warren, Gorham & Lamont, 2003 at A6.08[4][a].

⁹⁵ See Lisa M. Fairchild and Nan S. Ellis, *Rule 15c2-12: A Flawed Regulatory Framework Creates Pitfalls for Municipal Issuers*, 55 WASH. U. J. OF URBAN AND CONTEMPORARY LAW 587, 623 (1999).

⁹⁶ *Proposed Amendment to Municipal Securities Disclosure*, Exchange Act Release No. 34-60332 (July 15, 2009).

⁹⁷ "Program Dealer" is defined Rule G-34(c) as a dealer that submits an order directly to an Auction Agent for its own account, or on behalf of another account, to buy, hold, or sell ARS through the auction process.

would allow market participants to determine the extent to which the VRDO remarketing agent or liquidity provider holds a position in the VRDO at the time of the interest rate reset.⁹⁸

4. The Need for Mandatory Standards

Despite the SEC's and MSRB's proposed improvements to the municipal securities disclosure regime, much of the disclosure remains limited and non-standardized.⁹⁹ Other than the threat of litigation by the SEC or private parties for violations of the anti-fraud laws, there is no regulatory mechanism to ensure that disclosure in the official statement is adequate or timely. Beyond initial due diligence necessary under the MSRB suitability rules, underwriters have no duty to see that issuers continue to honor their contractual promises to provide continuing disclosure.¹⁰⁰ Issuers often lack the means to ensure accurate and complete disclosure in their offering documents and ongoing reports. In contrast to public companies, municipal issuers are not legally required to certify the accuracy of their financial statements in ongoing reports. Notwithstanding the size and importance of the municipal securities market, municipal issuers are not required to follow uniform accounting standards and disclosure requirements when preparing, presenting, and discussing their financial statements.¹⁰¹ And although some municipal issuers voluntarily present detailed information about risk from interest-rate swaps or other hedging, they are not required to do so.

Disclosure in the current system is weak because the Tower Amendment prohibits the SEC and MSRB from imposing disclosure obligations directly on municipal issuers.¹⁰² The SEC

⁹⁸ See *Request for Comment on Additional Increases in Transparency of Municipal Auction Rate Securities and Variable Rate Demand Obligations*, MSRB Notice No. 2009-43 (July, 14, 2009).

⁹⁹ See, e.g. Darrell Preston, *Muni Bonds Lag 13 Years Behind Corporate Disclosure*, BLOOMBERG NEWS SERVICE (June 12, 2009) (available at <http://www.bloomberg.com/apps/news?pid=20670001&sid=ajxjSUge7qdU>).

¹⁰⁰ See Ann Judith Gellis, *Municipal Securities Market: Same Problems—No Solutions*, 21 DEL. J. CORP. L. 427, 473-4 (1996).

¹⁰¹ White Paper.

¹⁰² See *SEC White Paper*, *supra* note 9, at 4.

and MSRB have reached the statutory limit of their authority to provide investors in municipal securities with adequate disclosure.

Nonetheless, there are complications with applying the corporate model of full registration and regulation to state and local governments. Because municipal issuers are themselves governments, SEC review of the disclosure documents of municipal issuers could present thorny issues of intergovernmental comity.¹⁰³ Moreover, the SEC could be overwhelmed by such a task, owing to the sheer number of municipal issuers. The resources that would be needed for the SEC to fully review the offering statements of 55,000 municipal issuers could outweigh the benefits of such an undertaking.

A more attractive approach would be to require *standardized* official statements and continuing disclosures which could be accessed by the public from a central location. The SEC should be given authority to bring enforcement actions not only for fraud but also for the failure to make disclosure in the requisite form.¹⁰⁴ Tax and rate payers will benefit from a reduction in municipal borrowing costs resulting from increased transparency. Investors may be willing to accept lower interest rates if greater transparency reduces the perceived risk of an investment.

CONCLUSION

Two problems, one internal and one external, coalesced to bring financial disaster to Jefferson County. At the internal level, poor governance brought about by political fragmentation fostered an environment where decision makers could not assess the long-term consequences of day-to-day decisions made for politically expedient reasons. Without the ability

¹⁰³ See Theresa A. Gabaldon, *Financial Federalism and the Short Happy Life of Municipal Securities Regulation*, 34 J. CORP. L. 739, 754-5 (2009) (discussing the concept of intergovernmental comity and its role in federal regulation of municipal securities) (“Intergovernmental Comity roughly translates into ‘making nice to another government.’”).

¹⁰⁴ *Id.* at 766.

to set durable policy objectives, the County Commissioners were vulnerable to the other, external problem—the pitfalls inherent in the municipal finance markets. The county commission acted on bad financial advice and fell prey to the sales pitches of bankers and underwriters.

Reforming the county governance structure to facilitate effective government is an issue that should be, and can only be, addressed at the state level. But the federal government can make changes to its regulatory regime for municipal bonds that could mitigate the effect of poor governance at the local level. Imposing fiduciary standards on financial advisors to municipalities and enhancing the quality of disclosure for municipal securities are two changes that would significantly improve the state of municipal finance. Sound and impartial financial guidance will help other municipalities avoid Jefferson County’s fate. Improved disclosure in municipal securities will attract more investors to the market and lower debt burdens for municipalities and their citizens.

But reforming the municipal finance market to provide better disclosure to municipalities, taxpayers, and investors—though timely and necessary—should not be thought of as a cure all for all of the problems that manifested themselves in Jefferson County. Recognizing both the limits and dangers of government intervention, Federal securities regulation is based upon the view that if investors are given all of the necessary information, they can make wise investment decisions. But responsibility for making those wise investment decisions rests with individuals, not government. As Louis Loss, regarded by many as the intellectual father of modern securities law, so aptly put it: “Congress did not take away from the citizen his inalienable right to make a fool of himself. It simply attempted to prevent others making a fool of him.”¹⁰⁵

¹⁰⁵ Louis Loss, *Fundamentals of Securities Regulation* 36 (1983).

Congress can—and should—do what is necessary to ensure that the same type of disclosures that investors and issuers receive in non-municipal securities markets are also made available to participants in municipal finance markets. But the responsibility for ensuring that our local governments use that information wisely rests with local governments and the citizens whose interests they represent.